Differentiated Businesses
(The Double U-curve)

By
Jean Estin
Chairman & CEO, Estin & Co

In businesses of more of less *standardized* products or services (mature industries, core mass-market products, low value-added services, etc.), competitive factors are simple: market share, and scale effects (more or less decisive depending on the business); technology, location and factor costs. Costs are structurally lower for leaders than for followers. Prices are similar or the same for all players. Margins are structurally higher for leaders. In the long term, the industry will concentrate (see table 1).

In businesses of *strongly differentiated* products or services, the nature of competition is more complex (luxury goods, professional services, high value-added financial services, high technology, cutting-edge health, specialty foods and ingredients, audiovisual production, etc.) (see table 2).

Costs between competitors are structurally different: scale effect economics apply for larger players with extensive product ranges, but smaller, specialized players are less complex and have structurally lower costs. In between, mid-sized players have high costs due to the combination of too much complexity and insufficient scale.

Prices are also very different: large players command high price premiums thanks to their strong images and differentiation; small specialists with very specific and/or innovative products, services or technologies also command high price premiums; intermediate players – large or medium-sized, more commoditized, of less specificity, with a less differentiated image – are unable to command such premiums, and so have lower prices.

On either side, the value created by differentiation – provided it is sustainable – compensates, or *adds to*, the value created by differences in costs (see examples in tables 3 and 4).

This double curve, a *U-shape in prices* and an *inverted U-shape in costs*, creates a fatal combination for players in the middle; especially so as it becomes accentuated over time. Large players are very profitable, as are small, well-focused specialists. Intermediary players generally have low margins, and in the medium or long term will lose their independence.

For a large generalist leader and for a specialist, profitability is higher than apparent, as accounting ratios do not take into account, or at least not fully, the company's true assets: the cumulative investments in its brand or in support of it over time; the experience and expertise that its key people acquired during their careers; its reputation among clients; the intellectual capital of the company; its know-how. These assets are the real barriers to entry into such businesses. They are often only valued during a sale or when listing on the stock market.

Managing these businesses of high differentiation is complex.

For small specialized players, the main issues are stability (how to be consistently successful in adapting to the latest developments of their highly specialized market segments?), resilience (how to maintain key factors of differentiation or even renew them in the long term: technology; key people; image, products and services adapted to specific client segments), growth (how to grow – and how much? – without reducing differentiation, and without getting stuck in the middle of the U-shaped curve?), cost control, and the ongoing motivation of teams, which are difficult to replace.

The short- and medium-term strategy is generally simple and is defined in relation to positioning, a type of clients, and a business model which is focused on a few levers of differentiation. The key is execution.

In the medium- to long-term, the problem is more complex. The company needs to optimize its trajectory across multiple dimensions: growth, investment, maintaining of its differentiation and increasing costs. Many players enter the trough of the "U" and never leave. For investors, valuing the growth strategies of small specialists is a challenge fraught with uncertainty.

For *leading large generalists,* the challenges are also numerous:

- Managing a diverse, highly differentiated offer, often including various business models, within a large company, where each addition must contribute to scale, to justify its place under the same roof.
- Managing complexity and its costs; to what extent can these be converted into value-added?
- Optimizing between price premiums, the corresponding potential markets and the capacity of the company's tools and teams to ensure the required degree of quality, specificity and innovation in a resilient manner over time.
- Managing, retaining and motivating "exceptional" teams and individuals, who require space and freedom for creativity and innovation, in the context of a large organization, which demands restrictive processes.
- Reproducing and adapting or renewing over time the features which form the basis of the company's success – its specificity, innovative character and uniqueness – despite the inevitable "averaging" and inertia of any large organization.

Some companies successfully address those challenges by maintaining diversity or innovation at certain steps of the value chain, while at others, they develop strong, transversal scale effects to drive and stabilize the whole:

- In luxury goods, strong brands and integrated distribution combine and reduce the potential volatility of creative lines and upstream businesses with strong specificity.
- In optics, large factories for basic lenses and shared commercial networks, combined with small partner laboratories, enable the customization of each lens for a given client.
- In pharmaceuticals (large laboratories), strong scale effects on in-house commercial and administrative authorization teams are combined with the outsourcing of specialists in pioneering R&D.

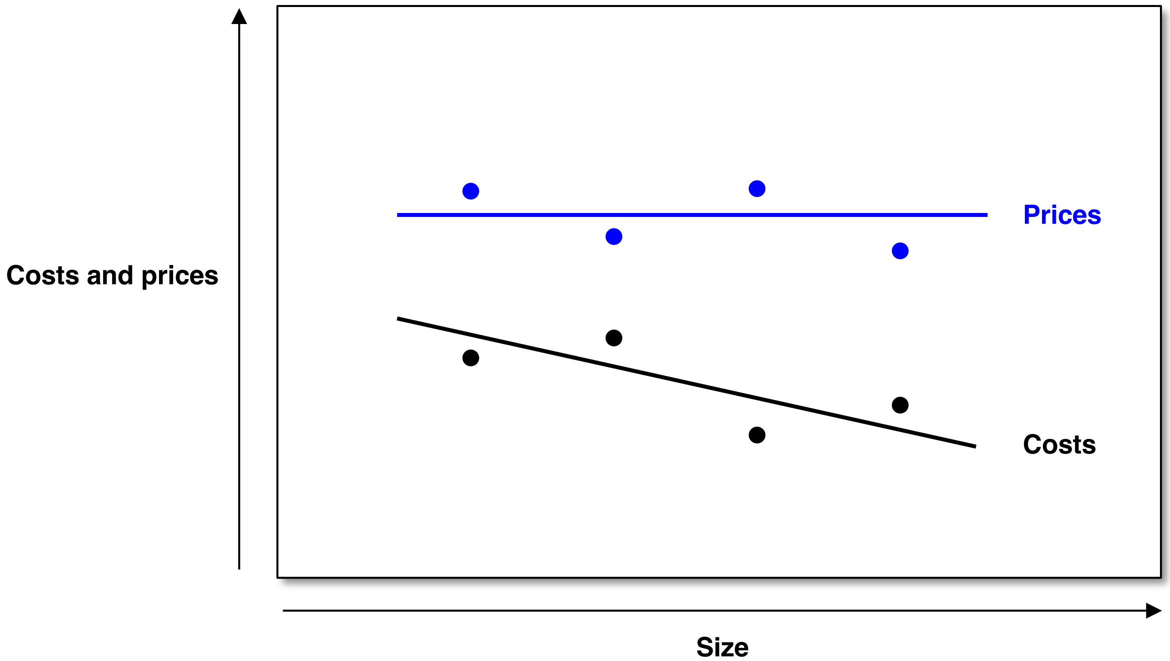
Others opt for managing their corporation as a holding company, with more or less sharing between businesses: portfolios of "houses" and brands in luxury goods; "practices" in consulting firms; concurrent and competing research teams in high technology.

Strategic choices will play a critical role (product lines, price premiums, client categories and associated market potentials, geographies, growth rate, renewal rate and level of innovation, R&D priorities, acquisitions, etc.).

Here too, models for the company's organization, for how it operates and for the motivation of its key people are key, both to manage businesses and teams, and to integrate acquisitions.

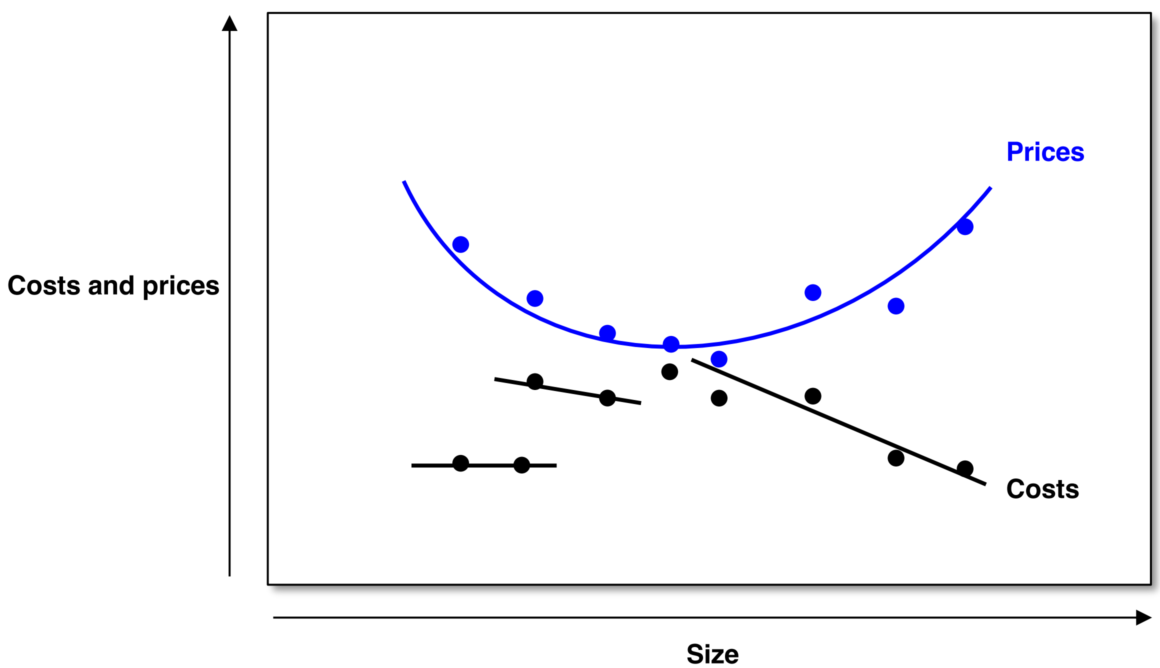
- Table 1 -

Standardized businesses: evolutions of costs and prices



- Table 2 -

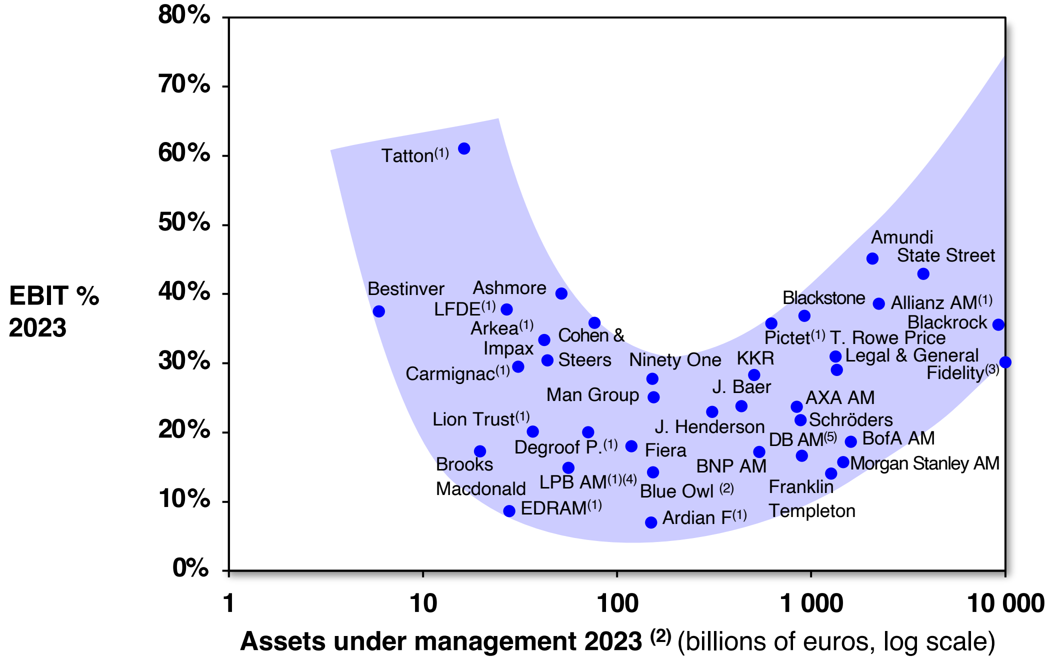
Differentiated businesses (the double U-curve)



- Table 3 -

Asset management is more profitable for large institutions (scale effects on low-margin products) or focused players with high management performance (specialization)

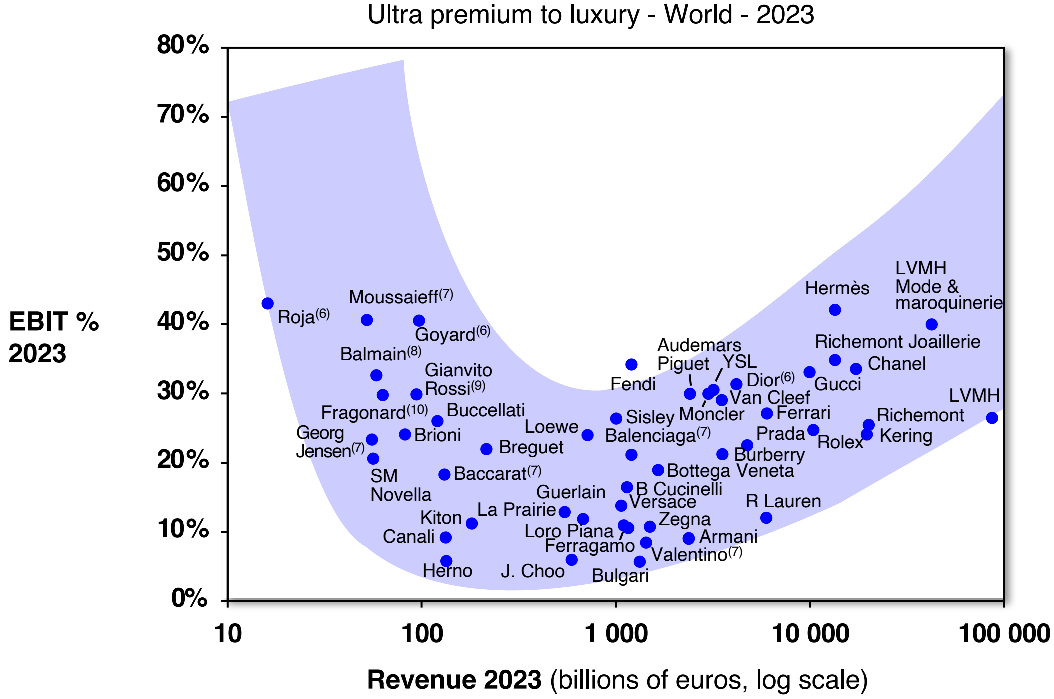
Asset Management - World - 2023



- Table 4 -

Luxury is more profitable for major houses (scale effects under the brand and in distribution) or for niche players

Ultra premium to luxury - World - 2023



Notes for table 3 (Asset Management): (1) 2022; (2) For groups, only asset management activities; (3) Assets under management = €12,000B ; (4) LBP = La Banque Postale; (5) DB = Deutsche Bank ;
Notes for table 4 (Luxury Goods): (6) 2022; (7) 2021; (8) 2015; (9) 2016; (10) 2018; data estimated for Audemars Piguet, Breguet, Buccellati, Rolex and Van Cleef.
Sources: annual reports, Orbis, Refinitiv, Pappers, interviews, Estin & Co analyses and estimates

In large, developed countries (United States, Europe, Japan, etc.), where clients (both companies and consumers) are increasingly sophisticated, these businesses represent a growing share of the economy, or at least of the part of the economy that remains competitive.

In these businesses, high margins come from price premiums resulting from strong, sustainable differentiation, more than from cost competitiveness, or at least in addition to it. The relevant growth strategies, operating models and best practices in execution are all specific. In general, intermediate positionings and average operating models have no long-term future. Business polarization is becoming the norm.

Jean Estin
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Estin & Co is an international strategy consulting firm, with offices in Paris, London, Zurich, New York and Shanghai. The company assists senior executives of major European, North American and Asian corporations with their growth strategies, and managers of private equity firms with the analysis and valuation of their investments.